

## **MODEL NOTICES AND DISCLOSURES FOR PENSION RISK TRANSFERS**

### **Written Testimony of**

**Professor Jon Forman<sup>1</sup>  
University of Oklahoma  
College of Law  
Norman, Oklahoma**

**for the**

**ERISA Advisory Council**

**Washington, DC**

**August 18, 2015**

**Issue Chair James I. Singer and members of the ERISA Advisory Council:**

I want to thank the ERISA Advisory Council for this opportunity to help the Council and the U.S. Department of Labor make sure that participants and beneficiaries get the information that they need to make informed decisions about pension risk transfers. I am the Alfred P. Murrah Professor of Law at the University of Oklahoma College of Law where I teach courses on tax and pension law. Much of my research focuses on pension policy.

After a brief Executive Summary, Part I of my statement provides some specific comments on the ERISA Advisory Council's July 25, 2015 draft notices. Part II provides some short answers to specific ERISA Advisory Council questions that were addressed to me, as well as some additional recommendations related to your project.

The remainder of my statement discusses pension risk transfers in detail and offers some additional recommendations. First, Part III provides some background on the pension system. Second, Part IV provides some background on de-risking generally, and, finally, Part V explains the rules governing both lump sum risk transfers and insurance annuity risk transfers.

---

<sup>1</sup> Jonathan Barry Forman ("Jon"), Alfred P. Murrah Professor of Law, University of Oklahoma; B.A. 1973, Northwestern University; M.A. (Psychology) 1975, University of Iowa; J.D. 1978, University of Michigan; M.A. (Economics) 1983, George Washington University; Professor in Residence at the Internal Revenue Service Office of Chief Counsel, Washington, D.C. for the 2009-2010 academic year; Member of the Board of Trustees of the Oklahoma Public Employees Retirement System, 2003-2011; Member of the University of Oklahoma Retirement Plans Management Committee, since 2012.

### EXECUTIVE SUMMARY

Government policies should be designed to help ensure that Americans have adequate incomes throughout their ever-longer retirements. (See Section III.B.)

The disclosure requirements should be designed to give participants the information that they need to make informed decisions. At the same time, however, the disclosure requirements should not be so burdensome on plan sponsors that it spurs them to terminate their plans. (See Section IV.D.)

Both model notices should have an instruction that reminds plan sponsors that they are acting as fiduciaries when they issue notices to participants and beneficiaries. (See Section II.C.)

Most assuredly, I believe that a plan sponsor breaches its fiduciary duties to its participants if it downplays the very real reductions in value that occur when a participant elects to take a lump sum rather than retaining her lifetime pension benefit. Fortunately, the government has ample authority to, at least, require that plan sponsors make full disclosures about how the proffered lump sums truly compare with the participants' lifetime pension benefits. All in all, I believe that the U.S. Department of Treasury and the IRS should revise the rules that are used to compute lump sums. At the very least, the relative value notices required by the IRS and the disclosure notices required by the U.S. Department of Labor should make plan sponsors clearly disclose the very real reductions in value that occur when a participant elects to take a lump sum rather than retaining her lifetime pension benefit. (See Section II.A & subsection V.B.3.)

My sense is that many participants take their money out of their pension plans after they terminate their employment because they are under the mistaken belief that they should or because they do not believe that their retirement savings are safe with that past employer's plan. The Lump Sum Notice should strive to convey to participants that they can safely leave their money in the plan even after they terminate their employment. (See paragraph I.B.2.a.)

As information about other forms of wealth and income can be very useful in helping participants evaluate their risk transfer options, the Lump Sum Notice might also disclose some very general information about Social Security and about how housing and financial wealth can be used to generate retirement income. (See subsection I.B.1, at A.)

To help participants better evaluate their risk transfer options, the U.S. Department of Labor should host (or endorse) more retirement calculators. Both *Present Value of an Annuity* and *Principal Sum to Annuity* calculators should be provided. The U.S. Department of Labor should also design (or endorse) an individualized *Life Expectancy Calculator* to help participants get a better idea how long they and their spouses can expect to live. The U.S. Department of Labor should also prominently display or link to individual and joint life expectancy tables. (See paragraph I.A.2.d.)

TABLE OF CONTENTS

<b>I. Specific Comments on the July 25, 2015 Draft Model Notices.....</b>	<b>4</b>
<b>A. The Pension Transfer Notice (07/25/2015 draft) .....</b>	<b>4</b>
1. Comments on Selected Notice Paragraphs (in <i>bold italics</i> ).....	4
2. Additional Comments on the Pension Transfer Notice .....	5
<b>B. The Lump Sum Notice (07/25/2015 draft) .....</b>	<b>7</b>
1. Comments on Selected Notice Paragraphs (in <i>bold italics</i> ).....	7
2. Additional Comments on the Lump Sum Notice.....	10
<b>II. Short Answers to Specific ERISA Advisory Council Questions and Related</b>	
<b>Recommendations .....</b>	<b>11</b>
<b>A. The Relative Value Regulations.....</b>	<b>11</b>
<b>B. The Scope of IRS Notice 2015-49 .....</b>	<b>13</b>
<b>C. Fiduciary Duties and Risk Transfer Communications.....</b>	<b>13</b>
<b>D. Information that Participants Need to Make Informed Decisions .....</b>	<b>13</b>
<b>III. Overview of the Pension System .....</b>	<b>13</b>
<b>A. Longevity Risk.....</b>	<b>13</b>
<b>B. Overview of the Sources of Retirement Income .....</b>	<b>14</b>
<b>C. Types of Pension Plans .....</b>	<b>15</b>
1. Defined Benefit Plans .....	15
2. Defined Contribution Plans.....	15
3. Hybrid Retirement Plans .....	16
<b>D. The Regulation of Employment-Based Plans .....</b>	<b>16</b>
<b>IV. Risk Transfer Strategies .....</b>	<b>17</b>
<b>A. De-risking Strategies, In General .....</b>	<b>17</b>
<b>B. Risk Transfer Strategies, In Particular.....</b>	<b>18</b>
<b>C. The Recent (and Coming) Increase in Pension Risk Transfers .....</b>	<b>18</b>
<b>D. The ERISA Advisory Council's Focus on Model Notices and Disclosures for Pension</b>	
<b>Risk Transfers .....</b>	<b>20</b>
<b>V. The Current Rules Governing Pension Risk Transfers .....</b>	<b>20</b>
<b>A. Standard Terminations .....</b>	<b>20</b>
<b>B. Lump Sum Risk Transfers .....</b>	<b>21</b>
1. The Mathematics of Converting a Lifetime Pension Benefit into a Lump Sum .....	22
2. The Mechanics of, and Rules Governing, Lump Sum Risk Transfers .....	23
3. The Relative Value of a Lump Sum is Almost Invariably Less than the Promised Lifetime	
Pension Benefit .....	26
<b>C. Insurance Annuity Risk Transfers .....</b>	<b>27</b>
<b>VI. Conclusion .....</b>	<b>28</b>
<b>Appendix.....</b>	<b>29</b>

## I. SPECIFIC COMMENTS ON THE JULY 25, 2015 DRAFT MODEL NOTICES

This Part includes comments on specific paragraphs of the two July 25, 2015 draft model notices that I reviewed. This Section also offers a few additional comments on the two model notices.

### A. *The Pension Transfer Notice (07/25/2015 draft)*

#### 1. Comments on Selected Notice Paragraphs (in ***bold italics***)

##### **What happens to my pension when it is transferred to an insurance company?**

Instead of receiving your pension annuity from your Plan, your pension will be converted to an annuity paid ***to you*** by the insurance company.

##### **Is my pension protected?**

Your benefits will no longer be protected by the assets in your employer's pension plan or by the federal pension insurance program, the Pension Benefit Guaranty Corporation. Instead insurance annuities are covered by the assets of the insurance company or by state guaranty associations, which provide some protection in the event that ***the insurance company fails***.

Comment: At some point in the notice, provide a link to: <http://www.pbgc.gov/>. In the July 25, 2015 draft Lump Sum Notice, the language used is:

More detailed information on the PBGC insurance program is available at the PBGC's website: <http://www.pbgc.gov/wr/benefits/guaranteed-benefits/maximum-guarantee.html>

##### **What are the guarantee limits for an annuity from an insurance company?**

Guarantee limits vary by state. Each state provides a guarantee of at least \$100,000 for the present value of an annuity. You can consult the National Organization of Life and Health Insurance Guaranty Associations (NOLHGA) table to find your state's guarantee limits. If the value of your benefit exceeds the amount protected by your State Guaranty Association, you can submit a claim for the excess in insolvency proceedings against the liquidated ***insurance company***.

Comment: At some point in the notice, provide a link to the relevant NOLHGA tables or at least to NOLHGA's frequently asked questions at <https://www.nolhga.com/policyholderinfo/main.cfm/location/questions>. See also National Organization of Life & Health Insurance Guaranty Associations, *The Nation's Safety Net* (2014), <https://www.nolhga.com/resource/file/NOLHGA%20Safety%20Net%202014.pdf>.

##### **How do I find the present value of an annuity?**

The present value of an annuity contract is calculated using several factors, including ~~the date a state insurance commission takes over a failed insurance company~~, the individual's age, and ~~the~~ interest ***rate*** in effect at the time. To get a rough idea of what the present value of your annuity might be today, you can go to ~~www.immediateannuities.com~~ ***the annuity calculator at https://www.immediateannuities.com/annuity-calculators/*** and put in your age, sex, where you live, and the amount of your monthly benefit.

Comment: The Immediateannuities.com calculator appears to provide estimates of what is happening in the insurance annuity market, but participants could also benefit from estimates of actuarially-fair annuities (i.e., those without insurance company “loads”).<sup>2</sup> As more fully explained in paragraph I.A.2.d below, I believe that the U.S. Department of Labor should host (or endorse) both an *Annuity Calculator* and a *Present Value of an Annuity Calculator*.

The Pension Transfer Notice might also give a simple example of the present value of an actuarially-fair annuity for, say, a 65-year-old female.<sup>3</sup>

### **How can I assess the financial health of an insurance company?**

Each insurance company is required to file an annual report which is usually posted ~~in~~ on its website. You can also look at the financial strength ratings provided by Weiss Ratings, which is independently compiled and can be found on the website TheStreet.com. Other rating companies include A.M. Best, S & P, Moody’s and Fitch, but they accept compensation from the insurance industry, which could create conflicts of interest.

Comment: At some point in the notice, provide a link to the financial strength ratings at [www.thestreet.com/insurers/](http://www.thestreet.com/insurers/).

### **Who can I contact for more information?**

[Employer to provide]

Comment: This could be a good place to refer participants to various retirement planning tools and calculators, such as those identified at Choose to Save, *Calculators*, <http://www.choosetosave.org/calculators/> (last visited Aug. 10, 2015).

#### **2. Additional Comments on the Pension Transfer Notice**

- a. *The Pension Transfer Notice might clarify the nature of the spousal benefits (QJSA) provided under the pension and under the insurance contract.*
- b. *The Pension Transfer Notice might explain the loss of ERISA protections.*
- c. *The Pension Transfer Notice might explain how disputes will be handled.*
- d. *The U.S. Department of Labor Should Host (or Endorse) More Retirement Calculators and Life Expectancy Tables.*

To help participants better evaluate their risk transfer options, the U.S. Department of Labor should host (or endorse) more retirement calculators.<sup>4</sup> Pertinent here, the U.S. Department of Labor already hosts a *Lifetime Income Calculator* that can be used to estimate monthly pension benefits for a typical retiree.<sup>5</sup> For example, for a 65-year-old participant retiring today

---

<sup>2</sup> See *infra* subsections V.B.1 & 3.

<sup>3</sup> See *infra* subsection V.B.1.

<sup>4</sup> These calculators would also be valuable aides for individuals with defined contributions plans, individual retirement accounts (IRAs), and other forms of retirement savings.

<sup>5</sup> U.S. Department of Labor, Employee Benefits Security Administration, *Lifetime Income Calculator*, <http://www.dol.gov/ebsa/regs/lifetimeincomecalculator.html> (last visited Aug. 10, 2015). The Department of Labor explains how its *Lifetime Income Calculator* works as follows:

with a current account balance of \$100,000, the calculator projects that she can expect to receive \$525 a month for the rest of her life (\$6300 per year =  $12 \times \$525$  per month).<sup>6</sup> Pertinent here, according to the *Advanced Annuity Calculator* at Immediateannuities.com, a 65-year-old man buying a \$100,000 lifetime annuity (on August 10, 2015) would receive \$566 per month for the rest of his life (\$6792 per year =  $12 \times \$566$  per month), while a 65-year-old woman would receive \$544 per month for the rest of her life (\$6528 per year =  $12 \times \$544$  per month).<sup>7</sup>

In addition to the *Lifetime Income Calculator*, the U.S. Department of Labor should provide (or endorse) more extensive calculators that could be used by participants to evaluate the choice between lifetime pension benefits and lump sums. Both *Present Value of an Annuity* and *Principal Sum to Annuity* calculators should be hosted. Ideally, these calculators should allow participants to use a variety of assumptions about life expectancy and rates of return, rather than just the fixed assumptions in the current *Lifetime Income Calculator*.<sup>8</sup>

The U.S. Department of Labor should also design (or endorse) an individualized *Life Expectancy Calculator* to help participants get a better idea how long they and their spouses can expect to live. To calculate your life expectancy, these calculators typically ask you about your

---

The calculator uses the safe harbor assumptions described in the [Advance notice of proposed rulemaking (ANPRM), *see infra* for the cite] for estimating future contributions, investment earnings, and inflation:

Contributions continue to Retirement Age at the Current Annual Contribution amount increased by 3 percent per year.

Investment returns are 7 percent per year (nominal).

An inflation rate of 3 percent per year is used for discounting the projected account balance to today's dollars.

In converting the account balances into lifetime income streams, the calculator uses the safe harbor annuity conversion assumptions described in the ANPRM:

A rate of interest equal to the 10-year constant maturity Treasury securities rate for the first business day of the last month of the period to which the statement relates (equal to 1.63% as of December 3, 2012 for statement periods ending December 31, 2012).

The applicable mortality table under section 417(e)(3)(B) of the Internal Revenue Code in effect on the first day of the last month of the period to which the statement relates. This is a unisex table (i.e., the annuity values are the same for males and females).

No insurance company load for expenses, profit, reserves, etc.

*See also* U.S. Department of Labor, Employee Benefits Security Administration, *Fact Sheet: Lifetime Income Illustration* (May 7, 2013), <http://www.dol.gov/ebsa/pdf/fsanprm.pdf>; U.S. Department of Labor, Employee Benefits Security Administration, *Pension Benefits Statement*, 78 Federal Register 26,727 (May 8, 2013), <http://webapps.dol.gov/FederalRegister/PdfDisplay.aspx?DocId=26998> (Advance notice of proposed rulemaking).

<sup>6</sup> At U.S. Department of Labor, Employee Benefits Security Administration, *Lifetime Income Calculator*, *supra* note 5, click on "Go to the Calculator"; enter Retirement Age: 65; Current Account Balance: \$100,000; Current Annual Contribution: \$0; Years to Retirement: 0; Statement Date: enter today's date; and click on "Calculate," and get Lifetime Income/Month for Participant With No Survivor Benefit: \$525). The results also show the \$476 per month that the participant (and spouse) would receive under a joint and survivor annuity (and the \$238 [50%] that would be paid to the surviving spouse), assuming that the participant and the spouse are the same age. *Id.*

<sup>7</sup> Immediateannuities.com, *Advanced Annuity Calculator*, <https://www.immediateannuities.com/annuity-calculators/> (last visited Aug. 10, 2015) (e.g., enter My Age Today: 65; My Gender: Male; State of Residence: DC; Income Start Date: Immediately; \$ Investment: \$100,000; click on "Calculate," and get Estimated Monthly Income: \$566).

<sup>8</sup> *See supra* note 5.

age, education, work, smoking habits, exercise regime, and family health.<sup>9</sup> At the very least, the U.S. Department of Labor might link to the very simple life expectancy calculator that the Social Security Administration hosts on its website.<sup>10</sup>

The U.S. Department of Labor should also prominently display or link to individual and joint life expectancy tables.<sup>11</sup> Moreover, as we should be particularly concerned about poverty among surviving spouses, it seems especially important for the U.S. Department of Labor to provide estimates of the joint life expectancies for couples of varying ages.<sup>12</sup> Most Americans underestimate their life expectancies.<sup>13</sup> For example, even though I have been researching in this area for years, I was surprised to learn that a 65-year-old man has a 50% chance of living to age 88 and a 25% chance of living to age 96.<sup>14</sup> In addition to providing life expectancy tables for the average population, it might also make sense to provide life tables for individuals who are healthier than the average population. While this statement does not offer any suggestions about which specific mortality table would be the correct one to use, Appendix Table 1 below does compare the 2011 Social Security area population life expectancy table with a few plausible alternatives.

*B. The Lump Sum Notice (07/25/2015 draft)*

1. Comments on Selected Notice Paragraphs (in ***bold italics***)

**A. What should I consider before making a decision on whether to accept the lump sum offer or keep my pension annuity?**

Whether you choose a lump sum ***or keep your lifetime pension benefit*** should be based on your specific circumstances, including your overall health and longevity expectations, your confidence in achieving long term investment returns which are higher than the Plan's assumptions, and whether you have sufficient additional retirement benefits ***and savings*** outside of this Plan.

---

<sup>9</sup> See, e.g., Dean P. Foster, Choong Tze Chua, & Lyle H. Ungar, *How Long Will you Live?*, <http://gosset.wharton.upenn.edu/~foster/mortality/> (last visited Aug. 10, 2015) (click on "Our longer version of the life calculator").

<sup>10</sup> Social Security Administration, *Retirement & Survivors Benefits: Life Expectancy Calculator*, available at <http://www.ssa.gov/planners/benefitcalculators.html> (last visited Aug. 10, 2015).

<sup>11</sup> See, e.g., Social Security Administration, *Period Life Table, 2011*, <http://www.ssa.gov/oact/STATS/table4c6.html> (last visited July 30, 2015); Elizabeth Arias, *United States Life Tables, 2010*, 63(7) NATIONAL VITAL STATISTICS REPORTS 1, 9 tbl.1 (2014), [http://www.cdc.gov/nchs/data/nvsr/nvsr63/nvsr63\\_07.pdf](http://www.cdc.gov/nchs/data/nvsr/nvsr63/nvsr63_07.pdf), available at Centers for Disease Control, *Life Tables*, [http://www.cdc.gov/nchs/products/life\\_tables.htm](http://www.cdc.gov/nchs/products/life_tables.htm) (last updated Jan. 6, 2014); Internal Revenue Service, *General Rule for Pensions and Annuities* 26 tbl.V (Ordinary Life Annuities, One Life), 27-42 tbl.VI (Ordinary Joint Life and Last Survivor Annuities, Two Lives) (Publication No. 939, 2013), <http://www.irs.gov/pub/irs-pdf/p939.pdf>.

<sup>12</sup> Again, see, e.g., Internal Revenue Service, *General Rule for Pensions and Annuities*, *supra* note 11, at 27-42 tbl.VI (Ordinary Joint Life and Last Survivor Annuities, Two Lives).

<sup>13</sup> See also Roberta Rafaloff, *Testimony for the ERISA Advisory Council on Model Notices and Disclosures for Pension Risk Transfers* (May 28, 2015), <http://www.dol.gov/ebsa/pdf/erisaadvisorycouncil2015risk8.pdf> (noting that "participants tend to underestimate future income needs and overestimate the wealth effect a lump sum offer conveys").

<sup>14</sup> Prudential, *Should Americans Be Insuring Their Retirement Income?* 3 (2013), <http://research.prudential.com/documents/rp/InsuringRetirementIncome.pdf?doc=InsuringRetirementIncome&bu=S&ref=website&cid=2>.



*Comment:* As information about other forms of wealth and income can be very useful in helping participants evaluate their risk transfer options, the Lump Sum Notice might also disclose some very general information about Social Security and about how housing and financial wealth can be used to generate retirement income.<sup>15</sup> For example, with respect to Social Security, the Lump Sum Notice might state something like:

***Social Security provides most elderly Americans (and their spouses) with monthly income that may cover at least a portion of their retirement income needs. While benefits vary with lifetime income, in 2015, the average monthly benefit paid to a retired worker was more than \$1300 per month. You can learn more about your Social Security benefits (if any) by contacting the Social Security Administration directly, and you can create an estimate of your future Social Security benefits with the Social Security Administration's Benefits planner, available at <http://www.ssa.gov/planners/index.html#a0=1>.***

Similarly, it might be useful if the Lump Sum Notice offered simple examples about: 1) how financial wealth can be used to purchase a lifetime annuity; and 2) about how housing wealth can be used to secure a reverse mortgage.<sup>16</sup>

## **2) How hard is it to invest the lump sum to provide equivalent lifetime income?**

To beat the Plan's benefit on your own, you have to do two things. First, you must achieve over your lifetime a higher investment return than the interest rate which was used by the Plan in calculating your lump sum. This *interest* rate appears below. ***You must achieve this higher investment return net of fees, but the fees that you will have to pay to invest and manage your money will almost certainly be significantly higher than the low fees that the Plan pays.***

Second, if you live longer than the projected mortality date in the mortality table used by the Plan, then you must earn even greater investment returns. The longer you live past the average projected mortality dated based on the mortality assumptions applicable under the Plan, the higher returns that you will need to avoid running out of money before your death. It is very hard for individuals to get superior returns to the Plan's returns. Some financial planners suggest *that* you invest your lump sum in a diversified portfolio of stocks and bonds which will subject you to the ups and downs of the stock market. ~~For example, a~~ repeat of the stock market experience of 2008 ***would be*** a difficult investment challenge from which to recover for a retiree who is drawing an income stream from a lump sum. To give yourself a lifetime income you must make withdrawals each year in retirement. You must determine the annual rate of return you will need to earn on your lump sum, minus the withdrawals, in order *to* maintain lifetime retirement income. If you (or your spouse) live longer than expected, you could exhaust the lump sum before you die. You might also take too much out each year, and run out of money too soon, or you might take out less money than you could have. If you use a financial advisor, you may wish to review the February 2015 Department of Labor proposed regulations on conflicts of interest of financial providers to participants who roll over lump sums to an individual retirement account (IRA) (<http://www.dol.gov/ebsa/newsroom/fsconflictsofinterest.html>)

---

<sup>15</sup> For more details about Social Security, see *infra* Section III.B.

<sup>16</sup> See, e.g., U.S. Department of Housing and Urban Development, *Home Equity Conversion Mortgages for Seniors*, [http://portal.hud.gov/hudportal/HUD?src=/program\\_offices/housing/sfh/hecm/hecmabou](http://portal.hud.gov/hudportal/HUD?src=/program_offices/housing/sfh/hecm/hecmabou) (last visited Aug. 10, 2015).



Comment: Because of the economies of scale that large defined benefit plans enjoy, they can negotiate much lower investment fees than individual investors.<sup>17</sup>

### **3) Can I buy an annuity in the market with my lump sum?**

Generally speaking, the annuity that you can purchase on your own with the lump sum will be less than the annuity provided by the Plan. Because women as a group live longer than men, women will face additional reductions in monthly benefit payments from a retail annuity. If you wish to make your own comparison, be careful to make an “apples to apples” comparison between the Plan’s annuity and the retail annuity quote. ***To get a rough idea of the kind of lifetime annuity that you could buy today, you can go to the annuity calculator at <https://www.immediateannuities.com/annuity-calculators/> and put in your age, sex, where you live, and the lump sum amount.***

### **4) Will I have to pay taxes if I take a lump sum?**

Yes you will have to pay taxes immediately (plus a 10% penalty the ***Internal Revenue Service [IRS]*** levies on people younger than 59 1/2 who cash out retirement assets), unless you roll over the funds into an IRA or another pension plan in compliance with IRS rules. You may wish to consult a financial advisor to discuss your specific tax situation. Guidance on the federal tax consequences of a lump sum distribution is provided in IRS Publication 575 titled “Pension and Annuity Income” (2014) which is available on the web at: <http://www.irs.gov/pub/irs-pdf/p575.pdf>. ***If you elect to receive a lump sum, you will receive explanations of your rollover options and of your income tax reporting responsibilities (if any).***

Comment: Participants getting a lump sum will receive a rollover notice and, later, an Internal Revenue Service Form 1099-R (although perhaps this latter form is not sent if the lump sum distribution takes the form of a trustee-to-trustee transfer from the Plan to an IRA or another pension plan).

### **6) Are there any other advantages to electing a lump sum?**

You may need cash today, and may not need your full pension. However, it is important to be sure that your other income from Social Security, company pensions, savings, and purchased annuities will be adequate for you and your spouse’s retirement.

Another reason to ~~elect~~ ***consider electing*** the lump sum is to consolidate your assets in one IRA. Alternatively, you ~~can~~ ***may be able to rollover*** your lump sum to your next employer’s pension plan or a prior employer’s pension plan.

Comment: The next employer’s Plan does not have to accept rollovers. See also the comment on Social Security, etc., for paragraph A.1, above.

---

<sup>17</sup> See, e.g., U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-07-21, PRIVATE PENSIONS: CHANGES NEEDED TO PROVIDE 401(K) PLAN PARTICIPANTS AND THE DEPARTMENT OF LABOR BETTER INFORMATION ON FEES 7 (2006); Brendan McFarland, *DB Versus DC Investment Returns: The 2009 – 2011 Update*, TOWERS WATSON INSIDER (May 2013), <http://www.towerswatson.com/en/Insights/Newsletters/Americas/insider/2013/DB-Versus-DC-Investment-Returns-the-2009-2011-Update>.

**7) Are there other legal concerns I should have?**

You ~~should~~ *may want to* talk to a local attorney ~~on~~ *about* the legal consequences of this decision (which can depend on your state or county). For example, if you *roll over* your lump sum to an IRA, it may not be protected from bankruptcy or your creditors anymore, while the pension was protected. In addition, state tax laws may treat pension payments differently than IRA payments. Similarly, state law could prohibit you from receiving Medicaid and other welfare benefits, until you spend down a lump sum to a small amount.

Comment: Attorneys are expensive, and many participants will be able to get the information that they need from certified public accountants or financial advisors. For large plans, unions and retiree groups may provide most of the needed information.

**B. What do I need to know about my pension before making this decision?**

**1) What are my benefit options under the Plan?**

If you do not elect the lump sum, your benefit options under the Plan are [to be provided by the employer]

Comment: If the options include immediate or deferred annuities, perhaps the notice should refer to the Pension Transfer Notice.

**2) Is the company offering a subsidy for early retirement and/or spousal benefits?**

Although a pension plan may include special subsidies to augment spousal benefits or to ~~incent~~ *encourage* early retirement, these subsidies may be absent from a lump sum, lessening its value in comparison to a stream of payments from the pension. Your Plan [does/does not] provide a “subsidy” (a benefit of greater value) which is/is not included in the lump sum. [Employer to revise as needed].

**4) Is my pension insured and what level of benefits is protected?**

Your pension is guaranteed by your employer and backed by the assets in its pension fund. In the event *that* your Plan is poorly funded and [insert name of employer here] goes bankrupt, *most* participants ~~could~~ *will* still receive all of the benefits *that* they would have received under the plan through the insurance program of the *federal government’s* Pension Benefit Guaranty Corporation (PBGC). More detailed information on the PBGC insurance program is available at the PBGC’s website: <http://www.pbgc.gov/wr/benefits/guaranteed-benefits/maximum-guarantee.html>

**2. Additional Comments on the Lump Sum Notice**

*a. The Lump Sum Notice should encourage participants to leave their retirement savings in the plan.*

My sense is that many participants take their money out of their pension plans after they terminate their employment because they are under the mistaken belief that they should or because they do not believe that their retirement savings are safe with that past employer’s plan. The Lump Sum Notice should strive to convey to participants that they can safely leave their money in the plan even after they terminate their employment.

*b. As already discussed in paragraph I.A.2.d above, the U.S. Department of Labor should host (or endorse) more retirement calculators and life expectancy tables.*

## **II. SHORT ANSWERS TO SPECIFIC ERISA ADVISORY COUNCIL QUESTIONS AND RELATED RECOMMENDATIONS**

This Part offers some thoughts on a few specific items that I was asked to address today.

### *A. The Relative Value Regulations*

When a lump sum alternative is offered to a participant, the minimum lump sum amount must be determined in accordance with certain actuarial valuation rules,<sup>18</sup> and the notice of plan benefits must explain the “relative value” of the lump sum when compared to the participant’s lifetime pension benefit.<sup>19</sup> The minimum lump sum must have a value equal to the actuarially-determined present value of the participant’s expected stream of lifetime pension benefits. Unfortunately, a lump sum calculated in that way is almost invariably *less* valuable than the promised lifetime pension benefit. For example, the minimum lump sum would rarely be enough to buy an insurance annuity<sup>20</sup> as generous as the promised lifetime pension benefit. Moreover, the valuation rules generally permit plan sponsors to calculate lump sums without regard to the value of certain early retirement benefits and other additional pension plan benefits.

In essence, in a lump sum transfer, the plan sponsor shifts risk to the participant but does not fully compensate her for taking on that risk or losing additional benefits. The plan sponsor saves money, but it is generally a bad economic deal for participants. At bottom, in the typical lump sum risk transfer, the interests of plans sponsors and participants are in direct conflict, and that raises some interesting issues. Pertinent here, in our voluntary pension system, plan sponsors are relatively free to design pension plans to their liking. That is the nature of the settlor function. On the other hand, when a plan sponsor administers its plan it acts as a fiduciary; that is, the plan sponsor must operate in the best interest of the participants (and beneficiaries).<sup>21</sup> Accordingly, a plan sponsor’s decision to offer a lump sum risk transfer is a matter of plan design that is viewed as a settlor function rather than a fiduciary function. On the other hand, when the plan sponsor implements that lump sum risk transfer, the plan sponsor acts as a fiduciary.

The first set of issues relates to the plan sponsor’s ability to offer a lump sum risk transfer. Amending the plan to offer participants the new lump sum benefit is pretty clearly a settlor function (not a fiduciary function). Accordingly, the plan sponsor is generally free to amend the plan to offer the lump sum benefit and is generally free to define the terms of that offer. For example, within certain regulatory limits the interest rate and the mortality table to be used in computing the lump sum will be identified in the plan amendment. As these selections involve the settlor function, a plan sponsor can select permissible interest rates and mortality

---

<sup>18</sup> I.R.C. § 411(c)(3); Treas. Reg. § 1.411(c)-1(e). For more a more detailed explanation, *see infra* Section V.B.

<sup>19</sup> Treas. Reg. §§ 1.417(a)(3)-1, 1.417(e)-1. For more a more detailed explanation, *see infra* Section V.B.

<sup>20</sup> An annuity is a financial instrument (i.e., an insurance contract) that converts a lump sum of money into a stream of income payable over a period of years, typically for life. *See also* U.S. Securities and Exchange Commission, *Annuities*, <http://www.sec.gov/answers/annuity.htm> (last updated Apr. 11, 2011); Investor.gov (U.S. Securities and Exchange Commission), *Annuities*, <http://m.investor.gov/investing-basics/investment-products/annuities> (last visited Aug. 10, 2015).

<sup>21</sup> ERISA § 404; I.R.C. § 401(a).

tables that are advantageous to it. Under the current rules, for example, a plan sponsor can gain a financial advantage for itself by selecting a so-called “lookback” interest rate from up to 17 months earlier—when that interest rate is higher (and so results in lower lump sums) than the rate that prevails at the time the lump sum offer is made. Similarly, until new mortality table regulations come into effect for 2017,<sup>22</sup> a plan sponsor can gain a financial advantage for itself by selecting the currently-required mortality table with its relatively shorter life expectancies (that result in fewer months of pension benefits and so lower lump sums).<sup>23</sup>

On the other hand, the second set of issues relates to the plan sponsor’s implementation of its lump sum risk transfer. Here, the plan sponsor must act as a fiduciary. The fiduciary duty under ERISA is the “highest duty known to the law,”<sup>24</sup> and fiduciary “decisions must be made with an eye single to the interests of the participants and beneficiaries.”<sup>25</sup> That makes it a real challenge for the plan sponsor, as its interests are economically adverse to the interests of its participants: the plan sponsor typically expects to save money by encouraging the participants to take lump sums that are almost invariably less valuable than the participants’ lifetime pension benefits.

Most assuredly, I believe that a plan sponsor breaches its fiduciary duties to its participants if it downplays the very real reductions in value that occur when a participant elects to take a lump sum rather than retaining her lifetime pension benefit. Fortunately, the government has ample authority to, at least, require that plan sponsors make full disclosures about how the proffered lump sums truly compare with the participants’ lifetime pension benefits. Acting as a fiduciary, I believe that the plan sponsor must be fully forthcoming with all the information that the participants (and beneficiaries) need to make informed decisions. It will never be enough for a plan sponsor to offer an unblemished picture of the pension risk transfer options: the plan sponsor must reveal the naked truth about lump sums, warts and all.

All in all, I believe that the U.S. Department of Treasury and the IRS should revise the rules that are used to compute lump sums, and, perhaps, those new rules should even require plan sponsors to pay a premium on top of the actuarially-determined present value that is currently required (although legislation would be needed before that change could happen).<sup>26</sup> At the very least, the relative value notices required by the IRS and the disclosure notices required by the U.S. Department of Labor should make plan sponsors clearly disclose the very real reductions in value that occur when a participant elects to take a lump sum rather than retaining her lifetime pension benefit. While the present actuarial valuation rules permit plan sponsors to offer lump sums that are based on out-of-date interest rates and mortality tables, the applicable notices should require the prominent disclosure of the “right” interest rates and mortality tables. The U.S. Department of Labor’s model Lump Sum Notice should also explain how hard it is to invest a lump sum to provide equivalent lifetime income (see, e.g., paragraph A.2 of the July 25, 2015 draft Lump Sum Notice) and how difficult it is to use a lump sum to purchase an insurance

---

<sup>22</sup> See Notice 2015-53, 2015-33 I.R.B. 1 (July 31, 2015), at 2-3.

<sup>23</sup> To be sure, as the I.R.C. § 411(d)(6) anti-cutback rule protects a participant’s accrued benefits, a plan sponsor should not be allowed to amend the plan to offer a lump sum alternative that actually cuts benefits.

<sup>24</sup> *Donovan v. Bierwirth*, 680 F.2d 263, 272 n.8 (2d Cir.), *cert. denied*, 459 U.S. 1069 (1982).

<sup>25</sup> *Id.* at 680 F.2d at 271.

<sup>26</sup> See *infra* subsection V.B.3

annuity that replicates the participants' lifetime pension benefit (see, e.g., paragraph A.3 of the July 25, 2015 draft Lump Sum Notice).

### *B. The Scope of IRS Notice 2015-49*

With a few exceptions, after July 9, 2015, Notice 2015-49 bars plan sponsors from implementing lump sum risk transfers for retirees in pay status.<sup>27</sup> More specifically, Notice 2015-49 generally prohibits plan sponsors from replacing ongoing defined benefit pension plan annuity payments with a lump sum payment or any other form of accelerated payment. As authority for this guidance, the Treasury and the IRS have latched onto I.R.C. § 401(a)(9) which generally requires plans to make minimum required distributions to retirees over age 70½, and it is clear that the regulations contemplated in Notice 2015-49 will bar lump sum payouts to those retirees. On the other hand, some analysts wonder whether those regulations will be broad enough to reach retirees in pay status under age 70½.<sup>28</sup>

### *C. Fiduciary Duties and Risk Transfer Communications*

Ultimately, the question in this Section is about the extent to which plan sponsor communications on pension risk transfers are governed by ERISA fiduciary rules as opposed to just being an instance of the plan sponsor communicating about plan terms as a settlor that is not bound by ERISA's fiduciary rules. Like many of you, I am not exactly sure where the line is. It is, at least, conceivable, that the plan sponsor is not always wearing its fiduciary hat when it communicates about the terms of the plan. On the other hand, it seems clear that when the communication occurs in the implementation of the plan, or in getting a participant to make an election under the plan, it is acting as a fiduciary. Accordingly, as more fully discussed in Section II.A above, I believe that virtually all communications (and the timing of those communications) with respect to pension risk transfers are fiduciary acts. In that regard, both model notices should have an instruction that reminds plan sponsors that they are acting as fiduciaries when they issue notices to participants and beneficiaries.

### *D. Information that Participants Need to Make Informed Decisions*

Parts IV and V below offer some additional recommendations about information that participants need to make informed decisions.

## **III. OVERVIEW OF THE PENSION SYSTEM**

### *A. Longevity Risk*

Longevity risk—the risk of outliving one's retirement savings—is probably the greatest risk facing current and future retirees.<sup>29</sup> At present, for example, a 65-year-old man has a 50%

---

<sup>27</sup> Notice 2015-49, 2015-30 I.R.B. 79 (July 9, 2015). See *infra* subsection V.B.2 for an additional discussion of Notice 2015-49.

<sup>28</sup> See, e.g., *IRS Shuts Down Pension Plan De-Risking Technique of Offering Lump Sums to Retirees in Pay Status* (Venable, News & Insights, Employee Benefits and Executive Compensation Alert, July 27, 2015), <https://www.venable.com/irs-shuts-down-pension-plan-de-risking-technique-of-offering-lump-sums-to-retirees-in-pay-status-07-27-2015/>.

<sup>29</sup> See, e.g., Youngkyun Park, *Retirement Income Adequacy With Immediate and Longevity Annuities* (Employee Benefit Research Institute, Issue Brief No. 357, 2011), [http://www.ebri.org/pdf/briefspdf/EBRI\\_IB\\_05-](http://www.ebri.org/pdf/briefspdf/EBRI_IB_05-)

chance of living to age 88 and a 25% chance of living to age 96, and a 65-year-old woman has a 50% chance of living to age 90 and a 25% chance of living to age 97.<sup>30</sup> The joint life expectancy of a 65-year-old couple is even more remarkable: there is a 50% chance that at least one 65-year-old spouse will live to age 94 and a 25% chance that at least one will live to 100.<sup>31</sup> In short, most individuals and couples will need to plan for the possibility of retirements that can last for 30 years or more.

### *B. Overview of the Sources of Retirement Income*

Elderly Americans can generally count on monthly Social Security benefits to cover at least a portion of their retirement income needs.<sup>32</sup> For example, in May of 2015, Social Security paid retirement benefits to 39.5 million retired workers, and the average monthly benefit paid to a retired worker was \$1334.21.<sup>33</sup> Most importantly, Social Security benefits are indexed each year for inflation as measured by the Consumer Price Index.<sup>34</sup> Roughly two-thirds of aged Social Security beneficiaries receive at least half of their income from Social Security.<sup>35</sup>

In addition, retirees use pensions, annuities, and a variety of other mechanisms to provide income throughout their retirement years.<sup>36</sup> While the ERISA Advisory Council's focus is on the lifetime pension benefits provided by defined benefit pension plans, in passing, it is worth noting that people rarely choose to buy annuities voluntarily.<sup>37</sup> In that regard, however, it is not altogether clear what the "right" level of annuitization is.<sup>38</sup> What is clear is that government

---

[2011\\_No357\\_Annuities.pdf](#); Ameriprise Financial, *Common retirement risks*, <https://www.ameriprise.com/retirement/retirement-planning/common-retirement-risks/> (last visited Aug. 10, 2015).

<sup>30</sup> Prudential, *Should Americans Be Insuring Their Retirement Income?*, *supra* note 14, at 3.

<sup>31</sup> *Id.*

<sup>32</sup> See, e.g., Jonathan Barry Forman, *Supporting the Oldest Old: The Role of Social Insurance, Pensions, and Financial Products*, 21(2) ELDER LAW JOURNAL 375, 385-89 (2014).

<sup>33</sup> *Monthly Statistical Snapshot, May 2015*, Social Security Administration, tbl.2 (June 2015), [http://www.ssa.gov/policy/docs/quickfacts/stat\\_snapshot/2015-05.pdf](http://www.ssa.gov/policy/docs/quickfacts/stat_snapshot/2015-05.pdf).

<sup>34</sup> Social Security Administration, *Fact Sheet: 2015 Social Security Changes*, <http://www.ssa.gov/news/press/factsheets/colafacts2015.pdf> (last visited Aug. 10, 2015).

<sup>35</sup> Social Security Administration, *Fast Facts & Figures About Social Security*, 2014 ii (Sept. 2014), [http://www.ssa.gov/policy/docs/chartbooks/fast\\_facts/2014/fast\\_facts14.pdf](http://www.ssa.gov/policy/docs/chartbooks/fast_facts/2014/fast_facts14.pdf) (65% of aged beneficiaries received at least half of their income from Social Security in 2012).

<sup>36</sup> See, e.g., Forman, *Supporting the Oldest Old: The Role of Social Insurance, Pensions, and Financial Products*, *supra* note 32, at 392-403.

<sup>37</sup> That is, the demand for annuities is lower than expected, and this shortfall has come to be known as the "annuity puzzle." See, e.g., Shlomo Benartzi, Alessandro Previtero & Richard H. Thaler, *Annuity Puzzles*, 25(4) JOURNAL OF ECONOMIC PERSPECTIVES 143, 154-57 (Fall 2011) (discussing behavioral and institutional factors leading to the low demand for annuities); Franco Modigliani, *Life Cycle, Individual Thrift, and the Wealth of Nations*, 76(3) AMERICAN ECONOMIC REVIEW 297, 307 (1986) ("[I]t is a well-known fact that annuity contracts, other than in the form of group insurance through pension systems, are extremely rare."); Menahem E. Yaari, *Uncertain Lifetime, Life Insurance, and the Theory of the Consumer*, 32(2) REVIEW OF ECONOMIC STUDIES 137 (1965) (analyzing the effect of the uncertainty of lifespan on consumer behavior).

<sup>38</sup> See, e.g., Barry P. Bosworth, Gary Burtless & Mattan Alalouf, *Do Retired Americans Annuitize Too Little? Trends in the Share of Annuitized Income* (Boston College Center for Retirement Research Working Paper 2015-9, 2015), [http://crr.bc.edu/wp-content/uploads/2015/06/wp\\_2015-9.pdf](http://crr.bc.edu/wp-content/uploads/2015/06/wp_2015-9.pdf) (finding little evidence that the annuity-like share of total income has fallen for aged families).

policies should be designed to help ensure that Americans have adequate incomes throughout their ever-longer retirements.

### *C. Types of Pension Plans*

The United States has a voluntary private pension system, and employers can decide whether and how to provide pension benefits for their employees.<sup>39</sup> However, when employers do provide pensions, those pensions are typically subject to regulation under the Employee Retirement Income Security Act of 1974 (ERISA).<sup>40</sup> Pension plans generally fall into two broad categories based on the nature of the benefits provided: defined benefit plans and defined contribution plans.

#### 1. Defined Benefit Plans

In a defined benefit plan, an employer promises employees a specific benefit at retirement. To provide that benefit, the employer typically makes payments into a trust fund, the fund grows with investment returns, and eventually the employer withdraws money from the trust fund to pay the promised benefits. Employer contributions are based on actuarial valuations, and the employer bears all of the investment risks and responsibilities. While many defined benefit plans allow for lump sum distributions, the default benefit is a retirement income stream in the form of an annuity for life.<sup>41</sup> For married participants, defined benefit plans (and some defined contribution plans) are required to provide a qualified joint-and-survivor annuity (QJSA) as the normal benefit payment, unless the spouse consents to another form of distribution.<sup>42</sup>

For example, a traditional defined benefit plan might provide that a worker's annual retirement benefit ( $B$ ) is equal to 2% times the number of years of service ( $yos$ ) times final average compensation ( $fac$ ) ( $B = 2\% \times yos \times fac$ ). Under this final-average-pay formula, a worker who retires after 30 years of service with final average compensation of \$50,000 would receive a pension of \$30,000 a year for life ( $\$30,000 = 2\% \times 30 yos \times \$50,000 fac$ ).

#### 2. Defined Contribution Plans

Under a typical defined contribution plan, the employer simply withholds a specified percentage of the worker's compensation and contributes it to an individual investment account for the worker. For example, contributions might be set at 10% of annual compensation. Under such a plan, a worker who earned \$50,000 in a given year would have \$5000 contributed to an individual investment account for her benefit ( $\$5000 = 10\% \times \$50,000$ ). Her benefit at retirement would be based on all such contributions plus investment earnings.

---

<sup>39</sup> This Section follows Jonathan Barry Forman & Michael J. Sabin, *Tontine Pensions*, 163(3) UNIVERSITY OF PENNSYLVANIA LAW REVIEW 757, 764-65 (2015).

<sup>40</sup> Employee Retirement Income Security Act of 1974 (ERISA), Pub. L. No. 93-406, 88 Stat. 829 (codified in scattered sections of 5, 18, 26, 29, 31 & 42 U.S.C.).

<sup>41</sup> Defined benefit plans are generally designed to provide annuities, i.e., "definitely determinable benefits . . . over a period of years, usually for life, after retirement." Treas. Reg. § 1.401-1(b)(1)(i).

<sup>42</sup> ERISA § 205; I.R.C. § 401(a)(11). A QJSA is an immediate annuity for the life of the pension plan participant and a survivor annuity for the life of the participant's spouse. *Id.*



Unlike defined benefit plans, defined contribution plans usually make distributions in lump sum or periodic distributions rather than life annuities.<sup>43</sup> Indeed, relatively few defined contribution plans even offer annuity options, and, in any event, relatively few participants elect those annuity options.<sup>44</sup>

### 3. Hybrid Retirement Plans

So-called “hybrid” retirement plans mix the features of defined benefit and defined contribution plans. For example, a cash balance plan is a defined benefit plan that closely resembles a defined contribution plan.<sup>45</sup> Like other defined benefit plans, employer contributions are based on actuarial valuations, and the employer bears all of the investment risks and responsibilities. Like defined contribution plans, however, cash balance plans provide workers with individual accounts (albeit hypothetical). A simple cash balance plan might allocate 10% of salary to each worker’s account each year and credit the account with 5% interest on the account’s balance. Under such a plan, a worker who earns \$50,000 in a given year would receive an annual cash balance credit of \$5000 ( $\$5000 = 10\% \times \$50,000$ ), plus an interest credit equal to 5% of the balance in her hypothetical account as of the beginning of the year.

#### *D. The Regulation of Employment-Based Plans*

Since it was enacted more than 40 years ago, the Employee Retirement Income Security Act (ERISA) has been amended numerous times, and a whole regulatory system has grown up to enforce its provisions. The key agencies charged with the administration of ERISA are the U.S. Department of Labor, the Internal Revenue Service (IRS), and the Pension Benefit Guaranty Corporation (PBGC).<sup>46</sup>

---

<sup>43</sup> See, e.g., TOWERS WATSON, INTERNATIONAL PENSION PLAN SURVEY: REPORT 2011, at 15 (2011), available at <http://www.towerswatson.com/en/Insights/IC-Types/Survey-Research-Results/2011/12/International-Pension-Plan-survey-2011> (indicating that lump sums distributions are “by far the most prevalent” form of distribution for defined contribution plans).

<sup>44</sup> In 2010, for example, just 18% of private industry workers in defined contribution plans had annuities available to them. U.S. Bureau of Labor Statistics, *National Compensation Survey: Health and Retirement Plan Provisions in Private Industry in the United States, 2010*, tbl.21 (Bulletin No. 2770, 2011), <http://www.bls.gov/ncs/ebs/detailedprovisions/2010/ebbl0047.pdf>. See also Paul Yakoboski, *Retirees, Annuityization and Defined Contribution Plans* 3, 5 (TIAA-CREF Institute Trends and Issues, Apr. 2010), [https://www.tiaa-crefinstitute.org/public/pdf/institute/research/trends\\_issues/ti\\_definedcontribution0410.pdf](https://www.tiaa-crefinstitute.org/public/pdf/institute/research/trends_issues/ti_definedcontribution0410.pdf) (finding that only around 19% of retirees with significant defined contribution plan assets but little defined benefit pension income annuitized a portion of their retirement savings); Carlos Figueiredo & Sandy Mackenzie, *Older Americans’ Ambivalence Toward Annuities: Results of an AARP Survey of Pension Plan and IRA Distribution Choices* 6 n.9 (AARP Research Report No. 2012-07, 2012), <https://www.tiaa-crefinstitute.org/public/pdf/institute/events/pdfs/Older%20Americans%20Ambivalence%20Toward%20Annuities.pdf> (noting that the 54<sup>th</sup> Annual Survey of Profit Sharing and 401(k) Plans carried out by the Plan Sponsor Council of America found that just 16.6% offered annuities as an option, while 60.2% offered periodic withdrawals); Beverly I. Orth, *Approaches for Promoting Voluntary Annuityization*, in 2008 RETIREMENT 20/20 CONFERENCE (Society of Actuaries Monograph No. M-RS08-1, 2009), <http://www.soa.org/library/monographs/retirement-systems/retirement20/2008/november/mono-2008-m-rs08-01-orth.pdf>.

<sup>45</sup> See Jonathan Barry Forman & Amy Nixon, *Cash Balance Pension Plan Conversions*, 25 OKLAHOMA CITY UNIVERSITY LAW REVIEW 379, 387 (2000).

<sup>46</sup> U.S. Department of Labor, Employee Benefits Security Administration, *About the Employee Benefits Security Administration*, <http://www.dol.gov/ebsa/aboutebsa/main.html> (last visited Aug. 10, 2015); Internal Revenue

Pension plans must be operated for the exclusive benefit of employees (and beneficiaries).<sup>47</sup> To protect the interests of plan participants, ERISA requires significant reporting and disclosure in the administration and operation of employee benefit plans.<sup>48</sup> ERISA also imposes extensive fiduciary responsibilities on employers and administrators of employee benefit plans.<sup>49</sup> In addition, prohibited transaction rules prevent parties in interest from engaging in certain transactions with the plan.<sup>50</sup> ERISA and the Internal Revenue Code impose many other requirements on retirement plans, including rules governing participation, coverage, vesting, benefit accrual, contribution and benefits, nondiscrimination, and funding.<sup>51</sup>

#### IV. RISK TRANSFER STRATEGIES

##### *A. De-risking Strategies, In General*

Over the years, plan sponsors have found it challenging to manage the risks associated with defined benefit plans. This has been particularly true since the Financial Accounting Standards Board (FASB) began requiring corporate employers to recognize the obligations associated with their defined benefit plans.<sup>52</sup> In that regard, recent fluctuations in the national economy have resulted in changes in the value of plan assets and in market interest rates, which, in turn, have led to volatility in the funded status of plans and in the pension contributions that plan sponsors are required to make.<sup>53</sup> In general, corporate employers have responded by freezing, terminating, or replacing their traditional defined benefit plans.<sup>54</sup> Many plan sponsors have also chosen to reduce their risks by managing their plan assets with so-called “liability driven investing” (LDI).<sup>55</sup> Finally, many plan sponsors are now focused on risk transfer

Service, *Tax Information for Retirement Plans*, <http://www.irs.gov/Retirement-Plans> (last visited Aug. 10, 2015); Pension Benefit Guaranty Corporation, *About PBGC*, <http://www.pbgc.gov/about> (last visited Aug. 10, 2015).

<sup>47</sup> ERISA § 404(a)(1)(A); I.R.C. § 401(a).

<sup>48</sup> ERISA §§ 101(a) et seq. *See also* U.S. Department of Labor, Employee Benefits Security Administration, *Reporting and Disclosure Guide for Employee Benefit Plans* (2014), <https://www.dol.gov/ebsa/pdf/rdguide.pdf>.

<sup>49</sup> ERISA § 404; I.R.C. § 401(a).

<sup>50</sup> ERISA § 406; I.R.C. § 4975. For example, an employer usually cannot sell, exchange, or lease any property to the plan.

<sup>51</sup> *See, e.g.,* Forman, *Supporting the Oldest Old: The Role of Social Insurance, Pensions, and Financial Products*, *supra* note 36, at 396.

<sup>52</sup> *See, e.g.,* Financial Accounting Standards Board, *FASB Improves Employers' Accounting for Defined Benefit Pension and Other Postretirement Plans* (2006), [http://www.fasb.org/jsp/FASB/FASBContent\\_C/NewsPage&cid=900000004155](http://www.fasb.org/jsp/FASB/FASBContent_C/NewsPage&cid=900000004155).

<sup>53</sup> U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-15-74, *PRIVATE PENSIONS: PARTICIPANTS NEED BETTER INFORMATION WHEN OFFERED LUMP SUMS THAT REPLACE THEIR LIFETIME BENEFITS 3* (2015), <http://www.gao.gov/assets/670/668106.pdf>.

<sup>54</sup> *See, e.g.,* William J. Wiatrowski, *Changing Landscape of Employment-based Retirement Benefits*, COMPENSATION AND WORKING CONDITIONS ONLINE (U.S. Department of Labor, Bureau of Labor Statistics, Sept. 29, 2011), <http://www.bls.gov/opub/mlr/cwc/changing-landscape-of-employment-based-retirement-benefits.pdf>; William J. Wiatrowski, *The last private industry pension plans: a visual essay*, 135(12) MONTHLY LABOR REVIEW 3 (2012), <http://www.bls.gov/opub/mlr/2012/12/art1full.pdf>; Justin Owens & Joshua Barbash, *Defined Benefit Plans: A Brief History* (Russell Investments 2014), <http://www.russell.com/documents/institutional-investors/research/defined-benefit-plans-a-brief-history.pdf>.

<sup>55</sup> *See, e.g.,* Advisory Council on Employee Welfare and Pension Benefit Plans, *Private Sector Pension De-risking and Participant Protections 13-14* (November 2013), <http://www.dol.gov/ebsa/pdf/2013ACreport2.pdf>.

strategies—strategies that transfer risk to insurance companies by purchasing annuities for participants (insurance annuity risk transfers) or transfer risk to participants by making lump sum payouts to the participants (lump sum risk transfers).<sup>56</sup>

### *B. Risk Transfer Strategies, In Particular*

Plan sponsors can significantly reduce their financial risks by using lump sum risk transfers and insurance annuity risk transfers. In a lump sum risk transfer, the participant gets a lump sum payout that has a value that is the actuarial equivalent of the remaining expected payments under her pension. In an insurance annuity risk transfer, the participant gets an insurance company annuity instead of her pension. In both types of risk transfers, the plan sponsor is able to reduce the size of its pension plan and its pension costs, for example, by reducing its PBGC premiums.<sup>57</sup> In short, pension risk transfers reduce risk for plan sponsors.

At the same time, however, pension risk transfers increase risks for participants. For example, participants who receive lump sum payouts must bear all of the longevity risk for making their money last for the rest of their lives; they must bear all the costs and risks of managing their investments; and their assets are no longer entitled to the creditor and other protections of ERISA.<sup>58</sup> Similarly, participants who receive insurance company annuities lose their ERISA protections, and they have their PBGC guarantees replaced by the less generous guarantees of state guaranty funds.

### *C. The Recent (and Coming) Increase in Pension Risk Transfers*

In recent years, we have seen a significant increase in these pension de-risking transactions. Increasingly, plan sponsors—especially those with frozen defined benefit plans—view their defined benefit plans as legacy liabilities that are no longer a strategic part of their current compensation packages. Through lump sum risk transfers and insurance annuity risk transfers, plan sponsors can reduce the number of plan participants. As a result plan sponsors can save money by reducing the plan's administrative costs and its ever-increasing PBGC premiums. Removing participants from the plan also reduces the size of the pension and so reduces the impact of market volatility on pension plan funding and contribution rates (and on corporate balance sheets).

---

<sup>56</sup> See, e.g., *id.* at 14-17. See also AonHewitt, *Pension Settlements Through Terminated Vested Lump Sum Windows: Insights into Plan Sponsor Experience* (Feb. 2013), [http://www.hekblog.com/wp-content/uploads/2013/03/Pension-Settlements-through-TV-Windows-3\\_18\\_13.pdf](http://www.hekblog.com/wp-content/uploads/2013/03/Pension-Settlements-through-TV-Windows-3_18_13.pdf); CFO Research & Mercer, *Taking the Next Step in Pension Risk Management* (July 2015), <http://www.cfo.com/research/index.cfm/download/14717490>.

<sup>57</sup> Plan sponsors have to pay both per-participant PBGC premiums and a variable-rate premium that is based on the plan's level of funding. See, e.g., Pension Benefit Guaranty Corporation, *Premium Rates*, <http://www.pbgc.gov/prac/prem/premium-rates.html> (last visited Aug. 10, 2015). The Bipartisan Budget Act provided for significant increases in PBGC premiums. *Id.*

<sup>58</sup> See, e.g., Roberta Rafaloff, *Testimony for the ERISA Advisory Council on Model Notices and Disclosures for Pension Risk Transfers* 5 (May 28, 2015), <http://www.dol.gov/ebsa/pdf/erisaadvisorycouncil2015risk8.pdf> ("The relative value statement does not even begin to evaluate the costs and risks assumed by the participant. In accepting the lump sum, the participant assumes the investment, mortality and longevity risks. The value of these risks, which the participant will pay if they attempt to turn the lump sum into lifetime income with a retail annuity, is not part of the relative value disclosure.").

Also, until the new mortality table regulations come into effect for 2017,<sup>59</sup> plan sponsors can still use the currently-required mortality tables to calculate lump sums—tables that reflect shorter life expectancies than the new mortality tables.<sup>60</sup> In that regard, as life expectancies increase, pensions will need to make monthly payments to participants over more years, and that means lump sum payouts will cost more. All in all, it is less expensive for plans to enter into lump sum risk transfers now.<sup>61</sup> Shifting to the new mortality tables is expected to result in a 5% to 7% increase in pension liabilities for the average plan.<sup>62</sup>

Recent legislation raised the interest rates that plans use to determine lump sum replacement amounts and so made lump sum payouts significantly less expensive.<sup>63</sup> To be sure, lump sum risk transfers and insurance annuity risk transfers are still relatively expensive in today's low-interest-rate environment, and they present significant challenges for currently-underfunded plans.

Pertinent here, however, higher interest rates generally have a bigger effect on a plan's liabilities than on its assets. Among other things, that means that (if and) when market interest rates increase, pension plan funding ratios will improve.<sup>64</sup> As a result, many currently underfunded plans will "become" fully funded, and once plans are 110% funded, many observers believe that many of those plans will then implement de-risking and termination strategies. Pertinent here, it is fairly easy for a plan sponsor to terminate a fully funded plan,<sup>65</sup> and

<sup>59</sup> See Notice 2015-53, *supra* note 22, at 2-3.

<sup>60</sup> See, e.g., Society of Actuaries, *RP-2014 Rates; Total Dataset* (2014), <https://www.soa.org/Files/Research/Exp-Study/research-2014-rp-mort-tab-rates.xlsx>, available at Society of Actuaries, *RP-2014 Mortality Tables* (2014), <https://www.soa.org/Research/Experience-Study/pension/research-2014-rp.aspx>; Society of Actuaries, *RP-2014 Mortality Tables Report 5 n.2* (Nov. 2014), <https://www.soa.org/Files/Research/Exp-Study/research-2014-rp-report.pdf>; see also American Academy of Actuaries, *Selecting and Documenting Mortality Assumptions for Pensions* (2015), [http://actuary.org/files/Mortality\\_PN\\_060515\\_0.pdf](http://actuary.org/files/Mortality_PN_060515_0.pdf).

<sup>61</sup> On the other hand, there is no similar cost savings for an insurance annuity risk transfer as insurance companies have already taken the new life expectancy projections into account in pricing their annuities. Once a plan adopts the new mortality tables however, annuities will look relatively better compared to the plan's liability.

<sup>62</sup> *Pension Risk Transfer Comes of Age* 4, 5, in *Pension Settlement Strategies: The Derisking Market Grows* (PENSIONS & INVESTMENTS advertising supplement July 27, 2015).

<sup>63</sup> I.R.C. § 417(e)(3); Pension Protection Act of 2006, 120 Stat. 780, 919-921, §§ 301-303 (2006); *as enhanced by* the Moving Ahead for Progress in the 21st Century (MAP-21), Pub. L. No. 112-141, 126 Stat. 405, 850-53, §§ 40221-22 (2012).

<sup>64</sup> A defined benefit plan's funding ratio is the ratio of its assets to its liabilities.

<sup>65</sup> See generally ERISA § 4041(b)(1)(D); Pension Benefit Guaranty Corporation, *Standard Terminations*, <http://www.pbgc.gov/prac/terminations/standard-terminations.html> (last visited Aug. 10, 2015); Internal Revenue Service, *Retirement Plans FAQs regarding Plan Terminations*, <http://www.irs.gov/Retirement-Plans/Retirement-Plans-FAQs-regarding-Plan-Terminations> (last updated Mar. 3, 2015); Harold J. Ashner, *PBGC Issues: Planning a Standard Termination—A Checklist for Practitioners*, 16(1) JOURNAL OF PENSIONS & BENEFITS 67 (Winter 2009), [http://www.keightleyashner.com/publications/PensionsBenefits\\_012009.pdf](http://www.keightleyashner.com/publications/PensionsBenefits_012009.pdf); Blaine Brickhouse, *Path to Defined Benefit Plan Termination* (2014), <http://www.findleydavies.com/images/ServiceLineLeftThumbnailsAndPDFs/Summary-of-the-Pension-Plan-Termination-Process-3-25-14-with-new-logo.pdf>; Society of Actuaries, *Plan Termination: Getting it Done!* (2011), <https://www.soa.org/files/pd/annual-mtg/2011-chicago-annual-mtg-118-4.pdf>; American Bar Association Retirement Funds, *Plan Administrator's Guide, Plan Termination* (2015), <http://www.abaretirement.com/ePAG/aba-0h0-plan-termination-web.html>; Nyhart, *Pension Plan Termination*, <http://www.nyhart.com/expertise/defined-benefit-pension-plan-termination/> (last visited Aug. 10, 2015).

participants in those “standard terminations” generally get lump sum payouts or insurance annuities: there is no way to stay with a plan that is terminating.<sup>66</sup>

*D. The ERISA Advisory Council’s Focus on Model Notices and Disclosures for Pension Risk Transfers*

Building on its prior work,<sup>67</sup> this year the ERISA Advisory Council is focused on the information that participants need to make informed decisions when they are faced with lump sum risk transfers and insurance annuity risk transfers.<sup>68</sup> More specifically, the ERISA Advisory Council is developing draft model notices and disclosures that can be used by plan sponsors, participants, and the public.<sup>69</sup> This task is critically important to both plans and participants. In the end, the guidance that is ultimately issued by the U.S. Department of Labor may have a significant impact on the size and nature of the defined benefit pension plan system and on the lifetime incomes of its participants.

All in all, I believe that the disclosure requirements should be designed to give participants the information that they need to make informed decisions. At the same time, however, those disclosure requirements should not be so burdensome on plan sponsors that it spurs them to terminate their plans.

**V. THE CURRENT RULES GOVERNING PENSION RISK TRANSFERS**

A variety of ERISA rules can have an impact on lump sum risk transfers and insurance annuity risk transfers.

*A. Standard Terminations*

At the outset, it is worth reiterating that it is fairly easy for a plan sponsor to terminate a fully funded pension plan.<sup>70</sup> In general, these standard terminations involve purchasing annuities from an insurer, although participants can also be offered lump sum payouts.<sup>71</sup> A terminating plan can only require a participant to accept a lump sum if the present value of her benefit is \$5,000 or less.<sup>72</sup> A typical termination involves numerous steps, including: calculating individual participant benefit amounts and payment form options, communicating information to plan participants, and distributing the assets. The whole process typically takes 12 to 18 months.<sup>73</sup>

Unless the participant elects otherwise, she will receive an insurance annuity that is equivalent to her pension. The selection of an annuity provider is a fiduciary decision, and the

---

<sup>66</sup> For a fuller explanation of standard terminations, see *infra* Section V.A.

<sup>67</sup> Advisory Council on Employee Welfare and Pension Benefit Plans, *Private Sector Pension De-risking and Participant Protections*, *supra* note 55.

<sup>68</sup> Advisory Council on Employee Welfare and Pension Benefit Plans, *Model Notices and Disclosures For Pension Risk Transfers* (Issue Statement 2015), <http://www.dol.gov/ebsa/pdf/ACmodelnotice1.pdf>.

<sup>69</sup> *Id.*

<sup>70</sup> See *supra* note 65 and accompanying text.

<sup>71</sup> ERISA § 4041(b)(3)(A); 29 C.F.R. § 4041.28(c).

<sup>72</sup> I.R.C. § 411(a)(11). For an explanation of the mathematics of these present value determinations, see *infra* subsection V.B.1.

<sup>73</sup> Brickhouse, *Path to Defined Benefit Plan Termination*, *supra* note 65, at 1.



plan sponsor must choose the “safest available” provider.<sup>74</sup> The plan sponsor must evaluate a potential annuity provider’s claims-paying ability and creditworthiness but cannot rely solely on ratings provided by insurance rating services. Factors that the plan sponsor should consider include:

- (1) the quality and diversification of the annuity provider’s investment portfolio;
- (2) the size of the insurer relative to the proposed contract;
- (3) the level of the insurer’s capital and surplus;
- (4) the lines of business of the annuity provider and other indications of its exposure to liability;
- (5) the structure of the annuity contract and guarantees supporting the annuities, such as the use of separate accounts; and
- (6) the availability of additional protection through state guaranty associations and the extent of those guarantees.<sup>75</sup>

A key step in any standard termination is providing an individualized notice of plan benefits to each participant.<sup>76</sup> These notices of plan benefits include general information about the plan and the data used to calculate each participant’s benefit, and they may also include the plan’s benefit election form. When a lump sum alternative is offered to a participant, the minimum lump sum amount must be determined in accordance with certain actuarial valuation rules,<sup>77</sup> and the notice of plan benefits must explain the relative value of the lump sum when compared to the participant’s lifetime pension benefit.<sup>78</sup> While plan sponsors have a good deal of flexibility about how to convey this information, the explanations “must be expressed to the participant in a manner that provides a meaningful comparison of the relative economic values of the two forms of benefit without the participant having to make [her own] calculations.”<sup>79</sup> For example, if a lump sum is offered, participants must be shown how that lump sum compares with the present value of the lifetime pension benefit.

### *B. Lump Sum Risk Transfers*

In a typical lump sum risk transfer, the employer amends its pension plan to provide participants with a choice between the lifetime pension benefit promised by the plan and a lump sum payout that has an actuarially-equivalent present value. Usually, the employer makes its “lump sum window” offer available to separated participants (also known as terminated deferred vested participants), and they are given a window of time (e.g., 90 days) to make their choice.

---

<sup>74</sup> 29 C.F.R. § 2509.95-1 (a/k/a Interpretive Bulletin 95-1, Interpretive bulletin relating to the fiduciary standards under ERISA when selecting an annuity provider for a defined benefit pension plan). *See also* Advisory Council on Employee Welfare and Pension Benefit Plans, *Report Of The Working Group On Retirement Distributions & Options* (2005), [http://www.dol.gov/ebsa/publications/AC\\_1105A\\_report.html](http://www.dol.gov/ebsa/publications/AC_1105A_report.html) (recommending that the U.S. Department of Labor revise Interpretive Bulletin 95-1 to clarify the prudent procedures for annuity selection and, if any, the prudent procedures for ongoing monitoring after an annuity purchase); *Bussian v. RJR Nabisco, Inc.*, 223 F.3d 286, 298 (5th Cir. 2000) (discussing the “safest available” standard); *Riley v. Murdock*, 83 F.3d 415 (4th Cir. 1996) (declining to apply the “safest available” standard).

<sup>75</sup> 29 C.F.R. § 2509.95-1(c).

<sup>76</sup> 29 C.F.R. § 4041.24.

<sup>77</sup> I.R.C. § 411(c)(3); Treas. Reg. § 1.411(c)-1(e).

<sup>78</sup> Treas. Reg. §§ 1.417(a)(3)-1, 1.417(e)-1.

<sup>79</sup> Treas. Reg. § 1.417(a)(3)-1.

For example, a separated participant who is not yet in pay status could be offered a lump sum that is the actuarial equivalent of her promised lifetime pension benefit. As more fully explained in subsection V.B.3 below, while that lump sum is the actuarial equivalent of her promised pension, because of the way that commercial annuity markets work, that lump sum could almost never be enough to buy a retail insurance annuity that would replicate the promised lifetime pension benefit.<sup>80</sup>

### 1. The Mathematics of Converting a Lifetime Pension Benefit into a Lump Sum

This subsection explains the mathematics of converting a lifetime pension benefit into an actuarially-equivalent lump sum as required by I.R.C. § 411(c)(3). Basically, a lump sum value is determined by converting a stream of projected future monthly benefits into a present value.<sup>81</sup> The mathematics is straightforward: you just need to know the applicable interest rate and the number of future monthly benefits that the participant expects to receive.<sup>82</sup> The interest rate (also known as the discount rate) is the rate of return that can be earned on the investment, and it is determined by market forces. The number of future monthly benefits that the participant is expected to receive is extrapolated from a mortality table.

Likewise, if you have a fixed principal sum to invest today, and you know the interest rate that a person can earn and how long that person is expected to live, you can determine the

<sup>80</sup> See, e.g., U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-15-74, PRIVATE PENSIONS: PARTICIPANTS NEED BETTER INFORMATION WHEN OFFERED LUMP SUMS THAT REPLACE THEIR LIFETIME BENEFITS, *supra* note 53, at 25-29.

<sup>81</sup> *Id.* at 60:

At the most basic level, determining a lump sum is converting a stream of projected future monthly benefits into a present value. A present value is the current worth of a future sum of money or stream of cash flows given a specified rate of return, also known as an interest rate or discount rate. The future cash flows are discounted at the discount rate, and the higher the discount rate, the lower the present value. In the context of a monthly benefit provided by a defined benefit pension plan, the stream of payments generally commences at an age specified by the plan, known as the normal retirement age, or at an optional early retirement age for eligible participants, and ends when the participant dies (or when the later of the participant and beneficiary dies, for a joint annuity). How long the stream of benefits will last depends on how long the participant lives, and lump sums take into account the probability that the participant will be alive at each future date. A mortality table is a common actuarial convention which shows, for each age, the probability that a person will die before his or her next birthday. (footnotes omitted).

See also Michael Kitces, *How to Evaluate the Pension Versus Lump Sum Decision, and Strategies for Maximization* (July 22, 2015), <https://www.kitces.com/blog/how-to-evaluate-the-pension-versus-lump-sum-decision-and-strategies-for-maximization/>.

<sup>82</sup> Here is a very simple present value example. Suppose you have \$1000 today, and you can earn 10% annual interest on an investment. That means you could earn \$100 interest in a year (\$100 = 10% × \$1000), and if you made that investment and held it for one year, you would have \$1100 at the end of the year (\$1100 = \$1000 + \$100), and the present value of the right to receive \$1100 in one year is \$1000. Similarly, if you kept your money in that investment for another year (two years total), it would grow to \$1210 (\$110 = 10% × \$1100; \$1210 = \$1100 + \$110); and the present value of the right to receive \$1210 in two years is \$1,000.

The general formula for the present value of a stream of payments is:

$$P = w [ (1 + r)^Y - 1 ] / [ (1 + r)^Y r ]$$

where P is the present value (= starting principal) of a stream of annual withdrawal amounts (w) given an interest rate (r) over a number of Years (Y). See, e.g., Moneychimp, *Annuity*,

<http://www.moneychimp.com/articles/finworks/fmpayout.htm> (last visited Aug. 10, 2015).



annuity amount that that person (i.e., the annuitant) will receive each period.<sup>83</sup> For example, if a person has \$100,000 to invest in an annuity today, can earn 5% interest per year, and can expect to receive 20 annual annuity payments (i.e., live for exactly 20 years), a simple annuity calculator shows that each annual annuity payment would be \$8024.26.<sup>84</sup> To be sure, pensions typically pay monthly pension benefits, but the mathematical principles are the same for yearly and monthly annuities.

By the same token, when the discount rate is 5%, the present value of a stream of 20 annual payments of \$8024.26 commencing one year from today is \$100,000.<sup>85</sup> In short, the present value of a 20-year, \$8024.26-per-year pension is \$100,000 (that is, when a 5% interest rate and a 20-year life expectancy are the correct actuarial assumptions). Accordingly, that \$100,000 would be the minimum actuarially-equivalent lump sum that must be offered to a participant in a lump sum risk transfer.

## 2. The Mechanics of, and Rules Governing, Lump Sum Risk Transfers

ERISA and the Internal Revenue Code impose a number of limits on the ability of plan sponsors to engage in lump sum risk transfers. At the outset, a plan sponsor's decision to implement a lump sum risk transfer is a matter of plan design that is viewed as a settlor function rather than a fiduciary function. On the other hand, when the plan sponsor implements that lump sum risk transfer, the plan sponsor acts as a fiduciary.<sup>86</sup> When acting as a fiduciary, the plan sponsor must:

- (1) operate solely in the best interest of the participants and beneficiaries and with the exclusive purpose of providing benefits to them;
- (2) carry out its duties prudently;
- (3) follow the plan documents (unless inconsistent with ERISA);
- (4) diversify the plan's investments; and pay only reasonable plan expenses.<sup>87</sup>

Also, whenever the plan sponsor makes a lump sum payout, the plan sponsor must comply with certain valuation rules.<sup>88</sup> Those rules ensure that any lump sum payout is the

<sup>83</sup> The general formula in footnote 82 can be rearranged to solve for the periodic annuity amount. The general formula is:

$$w = [ P(1 + r)^{Y-1}r ] / [ (1 + r)^Y - 1 ]$$

where P is the present value (= starting principal) of a stream of annual withdrawal amounts (w) given an interest rate (r) over a number of Years (Y). *Id.*

<sup>84</sup> I used Moneychimp, *Annuity Calculator*, [http://www.moneychimp.com/calculator/annuity\\_calculator.htm](http://www.moneychimp.com/calculator/annuity_calculator.htm) (last visited Aug. 10, 2015) (Starting Principal: \$100,000.00; Growth Rate: 5%; Years to Pay Out: 20; Make payouts at the: end of each year; click on "Calculate," and get Annual Payout Amount = \$8024.26).

<sup>85</sup> To check this result, I used Moneychimp, *Present Value of an Annuity Calculator*, [http://www.moneychimp.com/calculator/present\\_value\\_annuity\\_calculator.htm](http://www.moneychimp.com/calculator/present_value_annuity_calculator.htm) (last visited Aug. 10, 2015) (Annual Payout: \$8024.26; Growth Rate: 5%; Years to Pay Out: 20; Make payouts at the: end of each year; click on "Calculate," and get Present Value = \$100,000.02 [close enough]).

<sup>86</sup> ERISA § 404; I.R.C. § 401(a). *See also* Dana Muir & Norman Stein, *Two Hats, One Head, No Heart: The Anatomy of the ERISA Settlor/Fiduciary Distinction*, 93 NORTH CAROLINA LAW REVIEW 459 (2015); *Lee v. Verizon Communications, Inc.*, 954 F.Supp.2d 486 (N.D. Tex. 2013), *appeal docketed*, No. 14-10553 (5<sup>th</sup> Cir. Aug. 4, 2014).

<sup>87</sup> *See, e.g.*, U.S. Department of Labor, Employee Benefits Security Administration, *Meeting Your Fiduciary Responsibilities* 2 (2012), <http://www.dol.gov/ebsa/pdf/meetingyourfiduciaryresponsibilities.pdf> (explaining to employers how to administer their retirement plans).

<sup>88</sup> I.R.C. § 411(c)(3); Treas. Reg. § 1.411(c)-1(e).

actuarial equivalent of the promised lifetime pension benefit. Basically, the Internal Revenue Code and related guidance specify the applicable interest rates and mortality tables that must be used to determine the minimum value of the lump sum.<sup>89</sup>

As already mentioned, the new, longer-life-expectancy mortality tables will not come into effect until 2017.<sup>90</sup> As for interest rates, the Internal Revenue Code used to require plan sponsors to use low 30-year-Treasury-bill interest rates to determine the minimum value of the lump sum,<sup>91</sup> but now plan sponsors can use higher interest rates—calculated using three different corporate interest rates based on segments of the corporate bond yield curve.<sup>92</sup> These higher “applicable interest rates” have made lump sum payouts less expensive for plan sponsors—and less generous for participants. In addition, the interest rules permit plan sponsors to select an applicable interest rate from up to 17 months prior to the month in which the lump sum offer is made. That means that a plan sponsor can gain a financial advantage for itself by selecting a so-called “lookback” interest rate from up to 17 months earlier—when that interest rate is higher (and so results in lower lump sums) than the rate that prevails at the time the lump sum offer is made.<sup>93</sup>

Another rule lets plan sponsors ignore many additional pension plan benefits when calculating lump sum payout amounts. For example, a plan sponsor can calculate the lump sum for a separated participant based on that participant’s normal retirement benefit, even though that participant might have eventually been eligible for a subsidized early retirement benefit.

The Pension Protection Act of 2006 added new benefit restrictions that generally prohibit pension risk transfers that result in the plan having a funding ratio after the transaction that is below 80%.<sup>94</sup>

Historically, plan sponsors have usually implemented a lump sum strategy by offering the lump sum to separated participants, but more recently plans have also offered lump sums to retirees already in pay status.<sup>95</sup> On July 9, 2015, however, the IRS issued Notice 2015-49 which bars the lump sum strategy for most retirees in pay status.<sup>96</sup> More specifically, Notice 2015-49 informs taxpayers that the Treasury and the IRS intend to amend the minimum distribution regulations under I.R.C. § 401(a)(9) to generally prohibit defined benefit plans from replacing

---

<sup>89</sup> Plans may, but are not required to pay a larger sum.

<sup>90</sup> See *supra* note 22 and accompanying text.

<sup>91</sup> See, e.g., Notice 2002-26, 2002-15 I.R.B. 743 (requiring rates of interest based on 30-year Treasury securities during the four-year period ending on the last day before the beginning of the plan year).

<sup>92</sup> See, e.g., Internal Revenue Service, *Minimum Present Value Segment Rates*, <http://www.irs.gov/Retirement-Plans/Minimum-Present-Value-Segment-Rates> (last visited Aug. 10, 2015).

<sup>93</sup> To be sure, once an interest rate or other variable is set in a plan, it may later end up working against the plan sponsor, for example, if interest rates increase after the lump sum window offer locks in a relatively lower interest rate. Along these lines, for example, I vaguely recall that at least one airline pilot pension allowed employees to retire and take lump sum payouts that were based on the value of their pensions at the end of a prior quarter, and after the stock market fell in 2008, many pilots chose to retire and collect disproportionately higher lump sums as their plan terms required.

<sup>94</sup> ERISA § 206(g); I.R.C. § 436.

<sup>95</sup> See, e.g., Advisory Council on Employee Welfare and Pension Benefit Plans, *Private Sector Pension De-risking and Participant Protections*, *supra* note 55, at 16.

<sup>96</sup> Notice 2015-49, *supra* note 27.

ongoing annuity payments with a lump sum payment or any other form of accelerated payment.<sup>97</sup> Notice 2015-49 also provides that, with some exceptions, those regulations will be effective retroactively back to July 9, 2015. Notice 2015-49 marks a reversal of the position that the IRS had taken in a number of private letter rulings—rulings that, in effect, had permitted plan sponsors to offer lump sum payouts to participants already in pay status.<sup>98</sup>

In any event, I.R.C. § 411(a)(11) restricts a defined benefit plan's ability to cash out a participant's benefit without the participant's consent. Under certain circumstances, however, the plan does not need the participant's consent if the present value of her benefit is \$5000 or less.<sup>99</sup> If the participant's consent is needed and the participant is married, then spousal consent is also required.<sup>100</sup>

The following disclosures are currently required in a lump sum risk transfer:<sup>101</sup>

- (1) the material features of the optional forms of benefit available under the plan;<sup>102</sup>
- (2) the right, if any, to defer receipt of the distribution;<sup>103</sup>
- (3) the consequences of failing to defer;<sup>104</sup>
- (4) a description of the optional forms available under the plan, including: the amount payable in each form, the conditions for eligibility for each form, the relative value of the form compared to the qualified joint and survivor annuity (QJSA), and an explanation of relative value;<sup>105</sup> and
- (5) an explanation of the ability of the participant to roll over the lump sum distribution to another tax-qualified retirement plan or individual retirement arrangement, including the tax effects of doing so (the rollover notice).<sup>106</sup>

In addition,<sup>107</sup> plan sponsors and their advisors typically provide additional communication materials.

All in all, ERISA and the Internal Revenue Code provide a number of protections and disclosures for participants (and beneficiaries) who are offered lump sum alternatives to their lifetime pension benefits.<sup>108</sup>

---

<sup>97</sup> I.R.C. § 401(a)(9) generally requires plans to make minimum required distributions to retirees over age 70½, and it is clear that the regulations contemplated in Notice 2015-49 will bar lump sum payouts to those retirees over age 70½ who are in pay status. On the other hand, some analysts wonder whether those regulations will be broad enough to reach retirees under age 70½. *See, e.g., IRS Shuts Down Pension Plan De-Risking Technique of Offering Lump Sums to Retirees in Pay Status*, *supra* note 28.

<sup>98</sup> *See, e.g.,* Private Letter Ruling 201228045 (Apr. 19, 2012); Private Letter Ruling 201228051 (Apr. 19, 2012).

<sup>99</sup> I.R.C. § 411(a)(11); Treas. Reg. § 1.401(a)-11(c)(3).

<sup>100</sup> Treas. Reg. §§ 1.417(a)(3)-1, 1.401(a)-20.

<sup>101</sup> This paragraph follows Robert S. Newman, *Testimony for the ERISA Advisory Council on Model Notices and Disclosures for Pension Risk Transfers* (May 28, 2015), <http://www.dol.gov/ebsa/pdf/erisaadvisorycouncil2015risk10.pdf>.

<sup>102</sup> Treas. Reg. § 1.411(a)-11(c)(2)(i).

<sup>103</sup> *Id.*

<sup>104</sup> Notice 2007-7, 2007-1 C.B. 395, Q&A-32, 33; Prop. Reg. § 1.411(a)-11(c)(2)(vi).

<sup>105</sup> Treas. Reg. §§ 1.417(a)(3)-1, 1.417(e)-1.

<sup>106</sup> I.R.C. § 402(f); Treas. Reg. §§ 1.402(f)-1, 31.3405(c)-1. The IRS has provided safe harbor notices. *See* Notice 2009-68, 2009-2 C.B. 423, *updated by* Notice 2014-74, 2014-41 I.R.B. 670.

<sup>107</sup> *See, e.g.,* Craig Rosenthal, *Testimony for the ERISA Advisory Council on Model Notices and Disclosures for Pension Risk Transfers* 1-2 (May 28, 2015), <http://www.dol.gov/ebsa/pdf/erisaadvisorycouncil2015risk11.pdf>.

### 3. The Relative Value of a Lump Sum is Almost Invariably Less than the Promised Lifetime Pension Benefit

As we have seen, when a plan sponsor offers to replace a lifetime pension benefit with a lump sum, the minimum lump sum that is offered must be an amount that is actuarially equivalent to the promised lifetime pension benefit.<sup>109</sup> Basically, that means that the minimum lump sum must have a value equal to the present value of the participant's lifetime stream of pension benefits. Unfortunately, the applicable regulations permit the use of that lump sum amount even though that amount would almost never be sufficient to buy an insurance annuity as generous as the promised lifetime pension benefit.<sup>110</sup>

In fact, the lump sum is almost invariably *less* valuable than the promised lifetime pension benefit.<sup>111</sup> Indeed, experts estimate that the typical insurance company life annuity has a 12% "load" factor due to the combination of administrative expenses and adverse selection; that is, the typical insurance annuity provides benefits that are worth just 88% of an actuarially-fair annuity (i.e., a "money's worth ratio" of 88%).<sup>112</sup> Put differently, the payouts from actuarially-fair annuities would be around 15% higher than what can actually be purchased in current annuity markets.<sup>113</sup> In its recent study of lump sum risk transfers, the U.S. Government Accountability Office estimated that if a 65-year-old female participant were to accept a lump sum offer and then use that lump sum to purchase an insurance annuity, her monthly insurance

---

<sup>108</sup> It almost goes without saying that choosing between an annuity and a lump-sum payout is a "cognitively challenging task." Erzo F.P. Luttmer, *Testimony for the ERISA Advisory Council on Model Notices and Disclosures for Pension Risk Transfers* (May 28, 2015), <http://www.dol.gov/ebsa/pdf/erisaadvisorycouncil2015risk1.pdf>.

<sup>109</sup> See *supra* subsection V.B.1.

<sup>110</sup> This inadequacy is all the more likely now that the Pension Protection Act allows plan sponsors to use higher discount rates (the higher the discount rate, the lower the lump sum). See *supra* note 92 and accompanying text.

<sup>111</sup> Admittedly, for some participants—like those in ill health, the lump sum payout could be more valuable than the promised lifetime pension benefit.

<sup>112</sup> See MARK J. WARSHAWSKY, RETIREMENT INCOME: RISKS AND STRATEGIES 66 (2012) ("[D]ue to a combination of administrative costs and selection effects, the nominal annuity is assumed to have a money's worth ratio of 0.88, that is, the couple faces a 12 percent load factor on their annuity purchase.").

<sup>113</sup> *Id.* See also James Poterba, Steven Venti & David Wise, *The Composition and Drawdown of Wealth in Retirement*, JOURNAL OF ECONOMIC PERSPECTIVES 102 tbl.3 (Fall 2011) (providing that the actuarially-fair life annuity for a 65-year-old-man in 2008 was 9.95% and the AnnuityShopper price for a commercial life annuity at that time was just 8.46%, thus indicating a load factor of 17.6%:  $9.95\% \div 8.46\% - 1 = 17.6\%$ ); Jeffrey R. Brown, Olivia S. Mitchell & James M. Poterba, *The Role of Real Annuities and Indexed Bonds in an Individual Accounts Retirement Program* ("[T]he expected present value of annuity payouts is typically below the purchase price of the annuity . . .") in RISK ASPECTS OF INVESTMENT-BASED SOCIAL SECURITY REFORM 321, 321-22 (John Y. Campbell & Martin Feldstein eds., 2001); James M. Poterba & Mark Warshawsky, *The Costs of Annuity Retirement Payouts from Individual Accounts* ("The cost of such annuities, including both administrative and sales costs, the 'adverse selection' costs associated with voluntary purchase behavior, and return on capital for the insurance company offering the annuity policy, affect the retirement income that the participant receives for a given level of wealth accumulation."), in ADMINISTRATIVE ASPECTS OF INVESTMENT-BASED SOCIAL SECURITY REFORM 173, 173-74 (John B. Shoven ed., 2000); Benjamin M. Friedman & Mark J. Warshawsky, *The Cost of Annuities: Implications for Saving Behavior and Bequests*, 105 QUARTERLY JOURNAL OF ECONOMICS 135, 152 (1990) (arguing that actuarially-unfair annuity costs are a cause of lack of public participation in the individual life annuity market); Olivia S. Mitchell, James M. Poterba, Mark J. Warshawsky & Jeffrey R. Brown, *New Evidence on the Money's Worth of Individual Annuities*, 89 AMERICAN ECONOMIC REVIEW 1299, 1309 (1999) (finding that a typical retiree "would perceive a noticeable 'transaction cost' when purchasing an annuity from a commercial insurance carrier").

annuity benefit would be 24% smaller than her lifetime pension benefit would have been (also estimating a 17% reduction for 65-year-old males).<sup>114</sup>

In essence, in a lump sum risk transfer, the plans sponsor shifts risk to the participant but does *not* fully compensate her for taking on that risk. It is a bad economic deal for participants. The right *economic* answer is that plan sponsors should pay a premium to participants who take lump sum payouts. For example, instead of computing the lump sum as an amount equal to 100% of the present value of the participant's lifetime pension benefit, the plan sponsor really should pay a premium of, say, 15% on top of that present value; that is, the plan sponsor should make a lump sum payout equal to, say, 115% of the present value of the participant's lifetime pension benefit. That is how the lump sum payout rules should work. In any event, I agree with the U.S. Government Accountability Office that the Treasury and the IRS should reassess and revise the pertinent regulations.<sup>115</sup> More specifically, I believe that the Treasury and the IRS should revise the rules that are used to compute lump sums, and, perhaps, those new rules should even require plan sponsors to pay a premium on top of the actuarially-determined present value that is currently required (although legislation would be needed before that change could happen). At the very least, the relative value notices required by the IRS and the Lump Sum Notice required by the U.S. Department of Labor should make plan sponsors clearly disclose the very real reductions in value that occur when a participant elects to take a lump sum rather than retaining her lifetime pension benefit.

### *C. Insurance Annuity Risk Transfers*

In an insurance annuity risk transfer, the plan sponsor replaces the participants' pension benefits with retail insurance annuities. Basically, the plan sponsor purchases a group annuity contract, and the insurer distributes insurance annuity certificates to the covered individuals.<sup>116</sup> Under the minimum funding rules, however, the plan cannot purchase the group annuity unless the plan remains at least 80% funded after the transaction.<sup>117</sup> As with standard terminations, the selection of an annuity provider is a fiduciary function, and the plan sponsor must choose the "safest available" provider.<sup>118</sup> After the distribution of the certificates to individual plan participants, they cease to be covered by the plan.<sup>119</sup> That should also free the plan sponsor from any further fiduciary responsibilities with respect to those former participants.<sup>120</sup>

---

<sup>114</sup> U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-15-74, PRIVATE PENSIONS: PARTICIPANTS NEED BETTER INFORMATION WHEN OFFERED LUMP SUMS THAT REPLACE THEIR LIFETIME BENEFITS, *supra* note 53, at 25. *See also* Mark Miller, *Six Ways Pension Annuities Almost Always Beat a Lump Sum* (Mar. 2, 2012), <http://wealthmanagement.com/data-amp-tools/six-ways-pension-annuities-almost-always-beat-lump-sum>.

<sup>115</sup> U.S. GOVERNMENT ACCOUNTABILITY OFFICE, GAO-15-74, PRIVATE PENSIONS: PARTICIPANTS NEED BETTER INFORMATION WHEN OFFERED LUMP SUMS THAT REPLACE THEIR LIFETIME BENEFITS, *supra* note 53, at 51.

<sup>116</sup> *See, e.g.*, Robert S. Newman, *Testimony for the ERISA Advisory Council on Private Sector Pension De-risking and Participant Protections* 4-5 (June 5, 2013), <http://www.dol.gov/ebsa/pdf/covingtonburling060513.pdf>.

<sup>117</sup> *Id.* at 4; ERISA § 206(g); I.R.C. § 436.

<sup>118</sup> *See supra* Section V.A.

<sup>119</sup> 29 C.F.R. § 2510.3-3(d)(2)(ii).

<sup>120</sup> *Cf.*, Field Assistance Bulletin 2015-2 (July 13, 2015), <http://www.dol.gov/ebsa/pdf/fab2015-2.pdf> & 29 C.F.R. § 2550.404a-4 (relating to the safe harbor on defined contribution annuity distribution options).

## VI. CONCLUSION

Traditional defined benefit pension plans help ensure that participants will have adequate incomes throughout their retirement years. On the other hand, lump sums are likely to be quickly dissipated, leaving many beneficiaries impoverished in their later retirement years; and insurance annuities lack ERISA and PBGC protections. Ultimately, the U.S. Department of Labor should strive to ensure that plan sponsors act as fiduciaries in implementing pension risk transfer strategies and that, as a result, participants get all the information that they need to make informed decisions about their pension risk transfer options. At the same time, however, the U.S. Department of Labor should not use its rulemaking authority to impose such significant burdens plan on sponsors that it spurs them to terminate their plans.

Respectfully submitted,

*Jonathan Barry Forman ("Jon")*

Alfred P. Murrah Professor of Law  
University of Oklahoma College of Law  
300 Timberdell Road  
Norman, Oklahoma 73019  
(405) 325-4779  
fax (405) 325-0389  
[jforman@ou.edu](mailto:jforman@ou.edu)  
<http://www.law.ou.edu/faculty/forman.shtml>

OU LAW





## APPENDIX

Appendix Table 1 compares the death probabilities<sup>121</sup> for males in the 2011 Social Security area population life table<sup>122</sup> with a few plausible alternatives. The first set of alternative death probability estimates is from the Society of Actuaries (i.e., the so-called RP-2014 Mortality Tables for retirement plans),<sup>123</sup> and the second set of estimates are from the National Association of Insurance Commissioners (NAIC) (i.e., the so-called 2012 Individual Annuity Mortality Period Life [2012 IAM Period] Tables for those individuals who are likely to voluntarily buy a lifetime annuity).<sup>124</sup> For example, column 2 of Appendix Table 1 shows that a 65-year-old male in the Social Security area population (in 2011) had a probability of dying sometime during the year (i.e., the death probability) of 1.6% ( $q_i = 0.015553$ ), and column 3 shows that he had life expectancy of 17.66 years ( $e_i = 17.66$ ). On the other hand, column 5 of Appendix Table 1 shows that a *healthy* 65-year-old male annuitant in the Society of Actuaries' RP-2014 table had a death probability of just 1.1% ( $q_i = 0.011013$ ). Similarly, column 7 of Appendix Table 1 shows that a 65-year-old male in the NAIC 2012 IAM Period Table had a death probability of just 0.8% ( $q_i = 0.008106$ ).

---

<sup>121</sup> A death probability is the probability of dying within one year.

<sup>122</sup> Social Security Administration, *Period Life Table, 2011*, *supra* note 11.

<sup>123</sup> Society of Actuaries, *RP-2014 Rates; Total Dataset*, *supra* note 60.

<sup>124</sup> National Association of Insurance Commissioners [NAIC], *NAIC Model Rule for Recognizing a New Annuity Mortality Table for Use in Determining Reserve Liabilities for Annuities* (MDL-821, Jan. 2013), <http://www.naic.org/store/free/MDL-821.pdf>, at Appendix II. The 2012 Individual Annuity Reserving (IAR) Mortality Tables are designed for use in determining the minimum standard of valuation for individual annuity or pure endowment contracts issued after the effective date of the rule. *Id.* at § 4.D.



**Appendix Table 1. Mortality Rates ( $q_i$ ) and Life Expectancy ( $e_i$ ) for Males, Aged 55-80**

Age ( $i$ )	<i>Social Security Universe, 2011</i>		<i>Society of Actuaries, RP-2014</i>			<i>NAIC 2012 (<math>q_i</math>)</i>
	( $q_i$ )	( $e_i$ )	<i>Employee (<math>q_i</math>)</i>	<i>Healthy Annuitant (<math>q_i</math>)</i>	<i>Disabled Retiree (<math>q_i</math>)</i>	
55	0.007844	25.38	0.002788	0.005735	0.023369	0.003254
56	0.008493	24.57	0.003079	0.006099	0.023953	0.003529
57	0.009116	23.78	0.003407	0.006478	0.024557	0.003845
58	0.009690	22.99	0.003779	0.006877	0.025190	0.004213
59	0.010253	22.21	0.004204	0.007305	0.025868	0.004631
60	0.010872	21.44	0.004688	0.007771	0.026604	0.005096
61	0.011591	20.67	0.005240	0.008284	0.027414	0.005614
62	0.012403	19.90	0.005867	0.008854	0.028312	0.006169
63	0.013325	19.15	0.006577	0.009492	0.029314	0.006759
64	0.014370	18.40	0.007377	0.010209	0.030433	0.007398
65	0.015553	17.66	0.008277	0.011013	0.031685	0.008106
66	0.016878	16.93	0.009175	0.011916	0.033081	0.008548
67	0.018348	16.21	0.010171	0.012930	0.034633	0.009076
68	0.019969	15.51	0.011275	0.014067	0.036353	0.009708
69	0.021766	14.81	0.012498	0.015342	0.038253	0.010463
70	0.023840	14.13	0.013854	0.016769	0.040346	0.011357
71	0.026162	13.47	0.015357	0.018363	0.042647	0.012418
72	0.028625	12.81	0.017023	0.020141	0.045170	0.013675
73	0.031204	12.18	0.018870	0.022127	0.047935	0.015150
74	0.033997	11.55	0.020918	0.024345	0.050965	0.016860
75	0.037200	10.94	0.023188	0.026826	0.054287	0.018815
76	0.040898	10.34	0.025704	0.029608	0.057934	0.021031
77	0.045040	9.76	0.028493	0.032735	0.061945	0.023540
78	0.049664	9.20	0.031585	0.036258	0.066363	0.026375
79	0.054844	8.66	0.035012	0.040232	0.071235	0.029572
80	0.060801	8.13	0.038811	0.044722	0.076616	0.033234